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November 1, 2000

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, DC 20554

Ex Parte: Intercarrier Compensation for ISP-Bound Traffic – CC Docket No. 99-68

Dear Ms. Salas,

On Tuesday, October 31, 2000, Susanne Guyer, Ed Shakin and Frank Gumper, representing Verizon, met with Anna Gomez of Chairman Kennard's office to discuss intercarrier compensation for ISP-bound traffic. Verizon representatives discussed the potential cost of reciprocal compensation for terminating Internet traffic and why such compensation creates disincentives for CLECs to offer either residential or advanced services themselves. We also discussed why a transition from reciprocal compensation to a bill and keep arrangement would not harm CLECs or their shareholders. The attached materials were used in the discussions.

Pursuant to Section 1.1206(a)(1) of the Commission's rules, and original and one copy of this letter are being submitted to the Office of the Secretary. Please associate this notification with the record in the proceeding indicated above.

If you have any questions regarding this matter, please call me at (202) 463-5293.

Sincerely,

W. Scott Randolph
Director - Regulatory Matters

cc: Anna Gomez

Potential Cost of Reciprocal Compensation for Terminating Internet Traffic

Potential Cost of Reciprocal Compensation for Terminating Dial Up Internet Traffic

Residential Internet Usage

	1999	2000	2001	2002	Avg. Ann. Growth
Total US Households (000s)	103,900	105,000	106,400	107,700	1.28%
U S Online Households (000s)	43,600	47,300	51,400	56,900	9.66%
% Penetration	42%	45%	48%	53%	
Avg Minutes of Access Per On-Line HH Per Day	63	82	106	138	30.00%
Avg Minutes of Access Per On-Line HH Per Year	22,888	29,754	38,681	50,285	30.00%
Total Internet Access Minutes -- Residential	997,916,800,000	1,407,383,120,000	1,988,189,008,000	2,861,212,858,400	42.58%
% Broadband (xDSL, Cable modems, wireless)	4%	12%	20%	29%	
% Dial Up	96%	88%	80%	71%	
Dial Up Access Minutes	958,000,128,000	1,238,497,145,600	1,590,551,206,400	2,031,461,129,464	28.07%
% of Dial Up Internet Access Minutes That CLECs Terminate	**40.0%**	**50.0%**	**57.0%**	**66.7%**	
Dial Up Internet Access Minutes Terminated by CLECs	**383,200,051,200**	**619,248,572,800**	**906,614,187,648**	**1,354,306,065,335**	47.89%

ILEC Reciprocal Compensation Liability

Scenario 1: Declining Rates Without Cap				
Per Minute Recip. Comp. Rate		$0.0040	$0.00275	$0.0015
Total Recip. Comp. Liability		***$2,476,994,291***	***$2,493,189,016***	***$2,031,459,098***
Scenario 2: Declining Rates Plus Tapered Cap				
Caps on Ratio of Terminating to Originating Minutes		No Cap -- 18 to 1 Current Ratio	4:1 Ratio	2:1 Ratio
Adjusted dial up minutes with caps (assum 18:1 w/o caps)		619,248,572,800	201,469,819,477	150,478,451,704
Per Minute RC Rate		$0.0040	$0.00275	$0.0015
Total Recip. Comp. Liability		***$2,476,994,291***	***$554,042,004***	***$225,717,678***
Scenario 3: Comparable Liability Reduction W/O Cap				
Dial Up Internet Access Minutes Terminated by CLECs		*619,248,572,800*	*906,614,187,648*	*1,354,306,065,335*
Per Minute RC Rate Needed To Get to Scenario 2 Liability		***$0.0040***	***$0.00061***	***$0.00017***
Total Recip Comp Liability		*$2,476,994,291*	*$554,042,004*	*$225,717,678*

Sources:

Total US Households (000s)	Dean Witter Morgan Stanley, The Broadband Report Reaping What You Sow: ROI in the Broadband Market May 2000
U S Online Households (000s)	Dean Witter Morgan Stanley, The Broadband Report Reaping What You Sow: ROI in the Broadband Market May 2000
Avg Minutes of Access Per On-Line HH Per Year	Nielsen 8/14/00 Press Release; Cahners 3/26/00 Press Release; Thomas Weisel Partners, *Media Metrix's July Internet Usage Trends*, 8/23/00
% Broadband (xDSL, Cable modems, wireless)	Dean Witter Morgan Stanley, The Broadband Report Reaping What You Sow: ROI in the Broadband Market, May 2000
% of Dial Up Internet Access Minutes That CLECs Terminate	ALTS Press Release
Current Ratio of Terminating to Originating Minutes	Telecordia

For Comparable Forecasts See Also:

U S Online Households (000s)	Sanford Berstein & Co and McKinsey & Co., *Broadband!*, Jan 2000
% Broadband (xDSL, Cable modems, wireless)	Hoak Breedlove Wesneski & Co., *The Last Race for the First Mile*, 8/2/00

Why A Timely Transition From Reciprocal Compensation to Bill & Keep Will Not Harm CLECs or Their Shareholders

- Virtually all securities analysts that follow CLEC stocks are not factoring recip comp revenues into stock valuations unless and until that revenue is actually received. Thus, if the FCC were to establish a reasonable transition to Bill & Keep for all local traffic, including dial up Internet traffic, that decision would not adversely effect CLEC stock prices.

  - As **Vik Grover of Kaufman Bros.** wrote on Sept. 26, "It is our view that the Street has removed recip comp revenue from all CLEC models pending resolution of this matter [by the Congress or the FCC]."

  - On Sept. 28, **Manuel Recarey of Fahnestock & Co.** noted: "We believe RCN is different than all other CLECs due to its residential focus and strategy to construct its own network, thereby eliminating the need to interact with the competitor to provide service. In addition, *RCN does not face the issues that have negatively effected other competitive local carriers. It has almost no reciprocal compensation*, and switched access and long distance revenue counts for a small percentage of total revenue." [*Italics added*]

- If the FCC established a reasonable transition to Bill & Keep for dial up Internet traffic that effectively eliminated uncertainty about ILEC payment of carrier compensation to the CLECs during this transition, resolving the matter might actually give selected CLEC stocks a near term boost.

  - On Sept. 5, **J. Henry and W. Fore of Bear Stearns** opined that: "WorldCom's acquisition of Intermedia will likely be perceived as a positive move for Intermedia's investors in particular and CLEC investors in general. That said, we remain cautious on the group based on the mixed bag of positive and negative catalysts that the CLECs face in the near future. On the positive side, the CLECs offer highly compelling valuations coupled with the ongoing potential for improving fundamentals and additional M&A activity. On the negative side, many CLECs have excessive exposure to sticky issues such as reciprocal compensation, long distance, switched access, access to capital, and the Verizon strike. *...We believe that investors may be best served by sitting on the sidelines in the near term until these issues sort themselves out.*" [*Italics added*]

- Most CLECs like Focal Communications (FCOM) that count reciprocal compensation for dial up Internet traffic as material percentage of their total revenues have taken steps to dramatically reduce that percentage -- out of concern that investors will not capitalize business models that are based on an unreasonable regulatory arbitrages that will not last.

  - **Credit Suisse/First Boston** estimates that for Focal Communications recip comp as a percentage of total revenues declined from 73% in 1Q99 to 35% in 2Q00. (See Attachment A)

  - On Sept. 26, **Mark Kasten of CS First Boston** wrote: "We reiterate our Buy rating on FCOM shares.... [A]ssuming that reciprocal compensation as a revenue stream goes away beginning in January '02, we still come up with a 10-year DCF derived price target

of $84 (22% below our current target of $107*), or a six-fold increase from current levels.*" [*Italics added*]

- On Sept. 8 **Jeremy Bunting of Thomas Weisel Partners LLC.** advised his clients: "Focal Communications (FCOM: Strong Buy $29.75), in our view, represents one of the better values in the CLEC space. We believe that with reciprocal compensation issues behind it and a large customer focus, FCOM is poised for better-than-industry-average growth and operating performance."

- The FCC should not reward CLECs for attempting to hamstring the policymaking process by shamelessly claiming that replacing reciprocal compensation with Bill & Keep will somehow cause dial-up Internet access rates to go up by 30% or more.

  - On Sept. 14, **Gregory Miller of ING Barings** in a report *Reciprocal Compensation – The End of Another Arbitrage* noted: "The cost of providing dial-up access has been reduced by more than two-thirds over the past 24 months alone dues to dramatic advances in carrier grade modem databanks as well as by the dramatic decrease in the cost of long haul fiber optic circuits (an estimated 75% over the past two years alone). An increase in the price (which is unlikely anyway) of the short-haul circuits that are responsible for reciprocal compensation generation would have almost no impact on the cost of Internet access. Elimination of reciprocal compensation payments would only work to equalize the playing field with the CLECs that provide these circuits to ISPs on a bill and keep billing arrangements that have no reciprocal compensation associated with them."

    "The arbitrage is over – We understand that a few select CLECs are arguing that the adoption of such a proposal would not be feasible due to the fact that we are in an election year and that such a move by Congress would represent a tax on the Internet. We believe that is simply crazy. *In our view, nearly everyone now understands that the structure of reciprocal compensation simply represents a wealth transfer from the RBOC to the CLEC and that it cannot last.*"

    "Tax on the Internet – you have got to be kidding me. Many of the so-called emerging CLECs that have managed to tap the public equity markets on the premise of generating positive EBITDA sooner than their more fiber-intensive counterparts have done so largely as a result of their ability to book and bill reciprocal compensation revenues. Accordingly, we believe many of these particular CLECs have priced their services on basic PRI circuits at or below actual cost in hopes of more than offsetting such a loss with high reciprocal compensation payments (the arbitrage exploitation). If the existing trend in dramatically declining reciprocal compensation rates continues, as the arbitrage evaporates, then it will become increasingly difficult for these carriers, which may have mistakenly priced their services, to earn a reasonable rate-of-return. *We do not think any legislative body should be responsible for ensuring all companies generate a return on capital in spite of their own misplaced activities.*" (See Attachment B for full text of **Miller** report) [*Italics added*]

Credit Suisse / First Boston Estimates That There Are Currently Only a Handful of Publicly Traded CLECs That Have Reciprocal Compensation as a Material Percent of Revenues

Reciprocal Compensation as a Percent of Total Quarterly Revenue

	3Q98A	4Q98A	1Q99A	2Q99A	3Q99A	4Q99A	1Q00A	2Q99A
Adelphia	18%	22%	17%	27%	23%	23%	15%	10%
ELI	16%	19%	17%	18%	20%	18%	17%	17%
Focal	NA	NA	73%	71%	53%	41%	35%	35%
ICG	22%	26%	29%	34%	21%	20%	23%	22%
Intermedia	50%	6%	8%	9%	11%	11%	12%	3%
Wtd Average	**10%**	**13%**	**19%**	**22%**	**18%**	**18%**	**18%**	**14%**

Source: Credit Suisse / First Boston

As a Rule, CLECs Have Moved to Reduce Their Exposure To Recip Comp Revenues in Part Because Investors Do Not Believe This Particular Regulatory Arbitrage Will Last

Attachment A

ING BARINGS LLC

Attachment B

Telecommunications Services

Reciprocal Compensation - The End of Another Arbitrage

Gregory P. Miller (212) 409-5577
Christina Zaloum (212) 409-5571

September 14, 2000

- **Back again** – An issue we twice thought to be completely dead has again decided to haunt investors by rearing its ugly head in the form of a House Telecom Subcommittee hearing yesterday. It appears, through the recent announcements by several CLECs, that reciprocal compensation is purely an arbitrage that should not be inflicted upon the RBOCs indefinitely.

- **Too much for too little** – We estimate that the nation's largest carriers had been paying upwards of $1.0 billion of quarterly payments to selected CLECs for services that could not even be defined. Given that there is virtually no cost associated with providing terminating access to ISPs on a per minute basis, in that the ISP has already paid for the fixed cost portion of the circuit, there is almost no grounds by which it can be argued that this wealth transfer should continue.

- **Never bet on an arbitrage** – Even though MCI Communications was successful at exploiting an arbitrage opportunity in the long distance market in the mid and late 1980s – ultimately creating one of the only alternative long distance networks, we do not recommend investors bet on the carriers that are attempting to replicate this strategy today. The easy availability of capital in the telecom services market today has caused the half-life of any given arbitrage opportunity to last as long _____. We witnessed the same trend last year in the international wholesale long distance market where many carriers now teeter on the verge of bankruptcy, as that arbitrage evaporated almost overnight.

- **It's not Internet taxation** – The reason we wrote this report was due to the near shameless accusation by one industry executive who claimed that by eliminating the ability for certain CLECs to exploit this regulatory loophole, Congress would effectively cause the cost of dial-up Internet access to increase dramatically and that it would represent an effective "tax on the Internet" – one of the dirtiest phrases in Washington today. This is absolutely ridiculous.

- **Smallest part of the equation** – The cost of providing dial-up access has been reduced by more than two-thirds over the past 24 months alone due to dramatic advances in carrier grade modem databanks as well as by the dramatic decrease in the cost of long haul fiber optic circuits (an estimated 75% over the past two years alone). An increase in the price (which is unlikely anyway) of the short-haul circuits that are responsible for reciprocal compensation generation would have almost no impact on the cost of Internet access. Elimination of reciprocal compensation payments would only work to equalize the playing field with the CLECs who provide these circuits to ISPs on a bill and keep billing arrangements that have no reciprocal compensation associated with them.

- **Tough business models** – It becomes difficult to arrive at the magic 35% (plus) terminal EBITDA margin so many have assumed in respective valuation analyses by selling a wholesale circuit to an ISP that will never need the higher margin services the CLECs are intent upon selling. We recommend investors stick with the largest carriers (RBOCs) that would surely benefit from a closure of this loophole, as well as the CLECs like McLeodUSA and CTC Communications that generate little to no reciprocal compensation revenues.

The trend is reversing - Over the past several quarters there has become a growing concern over ever increasing payments that Regional Bell Operating Companies make to selected CLECs whose circuits are used by Internet Service Providers to terminate Internet bound traffic – the issue is all about reciprocal compensation. Companies like SBC Communications have paid upwards of $1 billion to CLECs in aggregate over the past 12 months for nothing more than phantom services. According to the Enhanced Service Provider ruling of 1983, that was more or less accidentally applied to dial-up Internet access, the RBOCs were arbitrarily prevented from assessing originating per minute access charges while CLECs without bill and keep agreements were allowed to impose access charges on the RBOCs to carry the very same traffic to the appropriate Internet Service Provider. Seems inequitable? It is. We believe it is. We believe it simply represents a wealth transfer from the Regional Bell to the CLEC. Recently the trend in payments has begun to change, not due to legislation, but more due to the forces of.

How it is generated - The key to generating reciprocal compensation if you are a certain CLEC is to make sure that you secure an ISP as a customer. Without ISP traffic, you have no reciprocal compensation. An ISP needs to carry its traffic from the RBOC central office (CO) to its point of presence (POP) so that it can effectively route the traffic. By leasing circuits from a CLEC, the ISP is routing traffic over the CLEC network, which then results in traffic that is eligible (under the regulatory loophole) for a payment that used to be as high as $0.009 per minute. Multiply that by billions and billions of minutes and we are left talking about numbers approaching one billion dollars quarterly. The Internet Service Provider customer is the key to the equation in that without it, reciprocal compensation traffic cannot be generated.

Not all of them do it – It would be completely unfair to suggest that all CLECs are in the business of selling what they label as an "access line" with the intention of not only gaining Wall Street's favor for capturing the coveted access line, but also with the intention to generate reciprocal compensation traffic. Several CLECs including McLeodUSA, NextLink Communications, CTC Communications, amongt a host of others, generate almost no reciprocal compensation traffic and associated revenues. These are a few examples of emerging telecom carriers that have attempted to fill the void created by the acquisitions of Teleport Communications Group and, to an extent, MFS Communications who were both attempting to create a local access infrastructure that would enable them to bypass the near monopoly competitor - the RBOC. When customers purchase services from these carriers, it is highly likely that the CLEC will be able to also sell the customer additional higher margin services, as the sales relationship is enhanced – ultimately enabling the carrier to achieve that magic 35% plus EBITDA margin many are forecasting over the next decade. It is unlikely that the sale of a PRI circuit to an ISP (from a reciprocal compensation based CLEC) will ever be able to sell higher margin products to carriers, and therefore, will also unlikely be able to achieve the expected profit margins for which its valuation is predicated upon.

No need for additional support – We have never been big advocates of attempting to select stock price direction predicated upon the interpretation of regulatory rulings, congressional hearings or resulting legislation. We believe that our economy has a unique way of rationalizing resources to the most competitive usage despite what our governing bodies in the telecom market may say or do. In fact, when we look at the Canadian telecommunications services market, which is dramatically smaller than that of the US, we see no regulatory favors like the Telecom Act of 1996 to the emerging carriers that could provide the upstarts with a near-term competitive advantage. In fact, without the ability to resell even a portion of the incumbents network at discounted prices, as is mandated in the United States, we have a relatively healthy competitive environment getting underway in the local access market with AT&T Canada (formerly MetroNet) and Global Telecom – both of which are deploying real assets with the intention of bypassing the incumbent's network. Unlike the resale, smart-build programs of the US, this Canadian dynamic will likely result in long-term real competition. We don't think the CLECs that are focused on arbitrage opportunities require anymore regulatory assistance.

A regulatory swing in the other direction – Apparently the House Telecom Subcommittee has proposed legislation H.R. 4445, the "Reciprocal Compensation Adjustment Act of 2000," that would most likely significantly reduce or even eliminate the arbitrage exploitation that certain CLECs are benefiting from, purely at the expense of the largest incumbent regional carriers. That could effectively leave several CLECs significantly exposed to the need to revise revenue and EBITDA expectations in the future, as their basic wholesale circuit sales to ISPs were based upon the assumption of windfall gains from ongoing reciprocal compensation payments from the RBOCs. Any change that would reduce the amount of reciprocal compensation payments to the CLECs would flow straight through to the bottom line.

The arbitrage is over - We understand that a few select CLECs are arguing that the adoption of such a proposal would not be feasible due to the fact that we are in an election year and that such a move by Congress would represent a tax on the Internet. That is simply crazy. Read on for our comments about the idea of taxation. The fact of reality is that nearly everyone now understands that the structure of reciprocal compensation simply represents a wealth transfer from the RBOC to the CLEC and that it cannot last. Either by legislative means or by the RBOC capturing the ISP customer itself, reciprocal compensation payments will trend toward zero for most of out nation's RBOCs over the long-term. The most recent data point we have is the ICG Communications 2001 earnings estimate revision where it is fairly clear that the new rates it will be charging for terminating ISP traffic is now less than $0.001 per minute compared with $0.009 a little more than a year ago. Revising both its revenue and EBITDA forecast by the same amount ($100 million), based solely upon changes in reciprocal compensation rates would conclude that this is a no-cost source of revenue and profit – purely an arbitrage opportunity.

Tax on the Internet – you have got to be kidding me. Many of the so-called emerging CLECs that have managed to tap the public equity markets on the premise of generating positive EBITDA sooner than their more fiber-intensive counterparts have done so largely as a result of their ability to book and bill reciprocal compensation revenues. Accordingly, we believe many of these particular CLECs have priced their services on basic PRI circuits at or below actual cost in hopes of more than offsetting such a loss with high reciprocal compensation payments (the arbitrage exploitation). If the existing trend in dramatically declining reciprocal compensation rates continues, as the arbitrage evaporates, then it will become increasingly difficult for these carriers who may have mistakenly priced their services, to earn a reasonable rate of return. We do not think any legislative body should be responsible for ensuring all companies generate a return on capital in spite of their own misplaced activities.

Major advances in the cost structure – In order for an ISP to provide service to an average customer, it must provide all aspects of the network to do so. Only three years ago, many of them decided to retain the management of that network in house. At that time, the average cost to provide the service was approximately $10 per subscriber, evidenced in many of the ISPs financials alone. With the advent of outsourcing in this market, largely a function of the creation of massive modem databanks that obviated the need for in house management of networks, that average cost of $10 per subscriber plummeted to roughly $3 per subscriber, effectively paving the way for a massive increase in marketing expenses, as the group became more competitive. Adding to the rapid pace of cost declines were also the dramatic reductions experienced in the long haul fiber optic market, where average pricing was cut by up to two-thirds over a period of 24 months. The bottom line: the temporary abatement in the rapid decline of PRI circuit capacity that has been predicated upon the exploitation of an arbitrage should have no material impact upon the underlying cost of providing dial-up ISP services. The assertion that the elimination of this arbitrage would represent a sort of tax on the Internet is, in our opinion, simply a strategy designed to gain sympathy with the populous.

A break-even business model at best? – With multiple short-falls and estimate revisions in the most recent quarter that have also been associated with the reciprocal compensation issue, we are becoming increasingly concerned that many respective business models are break-even at best. It is interesting to note that for some, both revenue and EBITDA revisions have trended down in direct proportion to the revision in the reciprocal compensation estimate. This would imply to us that the steadfastly denied assertion that reciprocal compensation is not a 100% EBITDA margin business is completely inaccurate. Maybe that is why the House Telecom Subcommittee has only now begun to hear proposed remedies for the Regional Bell Operating Companies. Unfortunately, we believe that without the steady stream of artificial support provided by reciprocal compensation payments, those sales of PRI circuits might turn out to be break-even at best. We find it unfortunate if these companies originally priced such circuits thinking the arbitrage would last indefinitely.

Another issue on the horizon - There is another reciprocal compensation like issue out there. Its called switched terminating access. Part of every long distance phone call we make is collected by the long distance carrier and then paid to an RBOC (usually) for both originating and terminating the call in the RBOC's region because the long distance company generally possesses no assets in the region which it can use to originate or terminate such calls. The average rate charged by the RBOCs and CLECs in metropolitan centers for terminating long distance calls is $0.012 and $0.025 per minute, respectively. In rural areas it is much higher (roughly $0.06 per minute) due to the lack of significant population density. It turns out that a few CLECs are charging the long distance carriers rural rates in metro centers claiming that their lack of density of customers justifies such a charge. It is an issue we all but guarantee will come back to haunt us again in the not so distant future, as many of the larger carriers have withheld payment for what they are calling egregious charges – sounding very similar to the arguments of the Regional Bells on reciprocal compensation.

Managing Director of Research at Paine Webber recently testified:

> Some are concerned that ending the payment of reciprocal compensation for Internet traffic will thwart investment in telecommunications. In my opinion, this is the wrong conclusion.

Furthermore,

Informed investors realize that the sustainability of revenues generated from [reciprocal compensation] is subject to great uncertainty given the ambiguity/inconsistency of the current regulations. It has been clear for years to knowledgeable entrepreneurs and investors that reciprocal compensation for Internet service is a source of revenue that could very well go away.[1]

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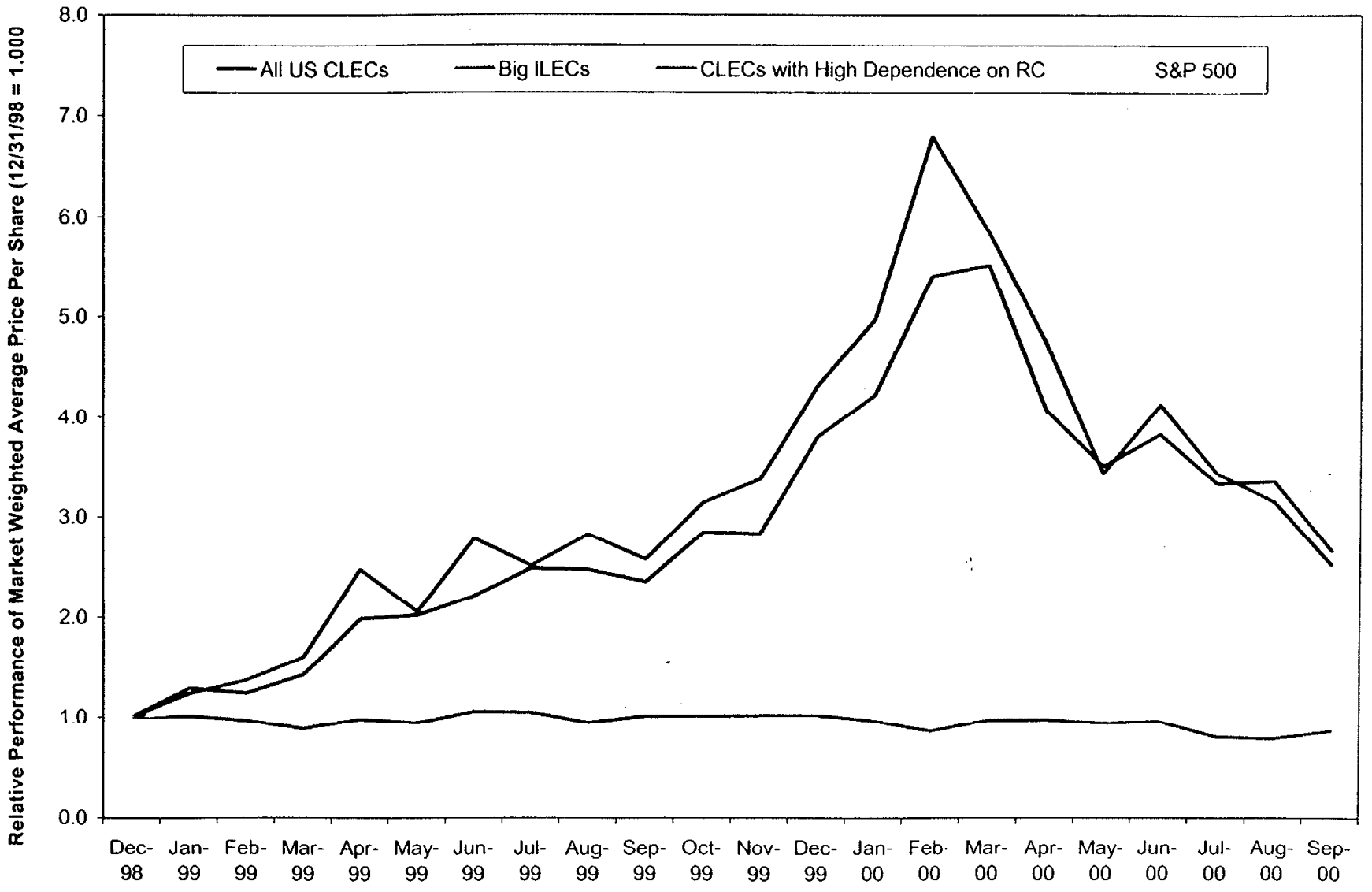
[1] *Reciprocal Compensation Requirements: Hearings on H.R. 4445 Before the Subcomm. on Telecommunications Trade & Consumer Protection*, 106 Cong. (June 22, 2000) (Testimony of Eric Strumingher, Managing Director, Research, Paine Webber).

Since Year End 1998, CLEC Stocks Including Those Carriers With Heavy Reliance on Reciprocal Compensation Revenues Have Dramatically Outperformed ILECs and Broad Market Average Despite Recent "Reversion To The Mean"



Source: Compustat
Note: CLECs With RC Dependence Include: Adelphia, Allegiance, Electric Light, Focal, Intermedia, & US LEC